Invested Earnings

Their Social Significance in Public Utility Financing

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I. INTRODUCTION

THE earnings of public utility companies which are invested "back into plant," flow into two kinds of property. First, there is that form of investment which is necessary to keep the property intact—expenditures for repairs, maintenance, and general up-keep. And second, there is that form of investment which increases property value. This form of investment covers earnings put into additions and betterments, or as sometimes termed —extensions and improvements.

The first of these, the general up-keep and maintenance charges, has never been severely questioned as being just charges that should be met from earnings. A long line of court rulings show conclusively that in considering what is to be a just rate or charge to the consumer or user of public utility service, all expenditures for keeping the corporation property up to its original value, must be taken care of. The Knoxville Case[1] which has been broadly cited as the leading case in this matter, holds:

> Before coming to the question of profit at all, the company is entitled to earn a sufficient sum annually to provide, not only for the current repairs, but for making good the depreciation and replacing the parts of the property when they come to the end of their life. It is entitled to see that from earnings the value of the property invested is kept unimpaired so that at the end of any given term of years the original investment remains as it was at the beginning.

[1] *Knoxville* v. *Knoxville Water Co.* (212 U. S. 1).

The second group of investments, however,—those earnings which go into increasing the capital value of a utility company by adding to and improving the property, brings forth a problem of no mean importance in public utility financing and public utility regulation. It is to be remembered that by far the larger portion of the earnings of public service corporations come from rates paid by the public. If such rates are sufficient not only to cover operating costs, maintain complete up-keep of property and pay a fair return on the investment, but in addition to provide a sufficient fund for extending and improving the plant and equipment, there is involved a problem of far reaching public and social import.

We realize this importance when we observe that earnings once invested in extensions and betterments generally connote an increased capitalization of plant—an added amount returned to the owners—which in turn calls for more earnings for dividend paying purposes. These additional earnings, made necessary by increased investment, may come from an increase in patrons, or they may be met by an increase in rates. In either case property value has been enhanced out of rates; an enhancement which amounts to an added return to the owners, provided dividend payments have been made.

Before calling attention to the different issues involved in this problem, it might be well to consider some of the facts of invested earnings in order to grasp clearly the nature and extent of this form of investment.

II. FACTS OF INVESTED EARNINGS

The following statement is compiled from the condensed balance sheets of all steam railroads in the United States as of June 30th, 1916. It shows the disposition that has been made of the corporate surplus. Inasmuch as the corporate surplus is built in the main from past earnings, the statement portrays the avenues into which a considerable amount of the surplus earnings of our railroads has gone.

DISPOSITION OF THE CORPORATE SURPLUS
All Steam Railroads as of June 30, 1916
(Statistics of Railways in the U. S.)
1916

Type of Carrier	Additions to the Property through Income and Surplus	Funded Debt Retired by Income and Surplus	Invested in Reserves from Surplus
Class 1 Carriers	$503,647,000	$58,702,000	$118,355,000
Class 2 Carriers	5,720,000	1,967,000	1,430,000
Class 3 Carriers	1,232,000	262,000	261,000
Non-operating Carriers	29,847,000	25,874,000	14,420,000
Switching and Terminal Lines	7,601,000	2,473,000	2,575,000
Totals	$548,047,000	$89,278,000	$137,041,000

(NOTE: In addition to the above totals there is an item of $85,082,000 of surplus which has not been specifically invested.)

It should be noted that from a total credit to corporate surplus of over eight hundred and fifty millions of dollars approximately five hundred and fifty millions has been put into additions to property. In addition to this building of property from earnings all but ninety millions has been used from the surplus in order to retire the funded debt—bonds, notes, etc.

During the five year period 1912–1916 the additions to property of the railroads from income and surplus show a very rapid growth—almost a complete doubling. The increase in these years for the Class 1 roads alone was approximately a quarter of a billion dollars. The total credits for each year, as they appear on the condensed balance sheet of the Class 1 roads, follows:

Status of the Account
ADDITIONS TO PROPERTY FROM INCOME AND SURPLUS
Class 1 Roads
(Figures show total appropriation as appearing on condensed balance sheets)
(Statistics of Railways in U. S. 1912 to 1916)

1912	$257,833,000
1913	387,764,000
1914	424,052,000
1915	412,266,000
1916	503,647,000

Invested earnings and the surplus problem made up a considerable part of the testimony and opinion both in the Eastern and Western rate cases[2] argued before the Interstate Commerce Commission. From these two cases several instances may be taken which show how earnings have been put into property.

The President of the Pennsylvania Company testified that since 1887 his company has put into the Pennsylvania lines east of Pittsburgh $262,000,000 from earnings. During all that time this company also paid its stockholders attractive dividends. This sum according to the statistical report of the Pennsylvania Railroad Company to the Commission for the year ending June 30, 1910, equals two-thirds of the total construction of the 2,123 miles owned by that company at that time.[3]

The financing of the Hudson River Tunnell gives another illustration. Quoting from the *London Statist:*[4]

> At the end of 1909 the total cost of the tunnel extension including real estate not permanently required for its use was $102,496,000, of which $35,000,000 has been charged against surplus income.

The Interstate Commerce Commission Reports cite another instance where regular dividends, never less than 6%, were paid the owners and in addition earnings were sufficient to enable the purchase of competing roads:[5]

> The Lake Shore and Michigan Southern on June 30, 1901, owned a majority of the capital stock of its competitor, the New York Central, Chicago & St. Louis Railroad Co. A majority of the stock of its connection, the Pittsburgh & Lake Erie Railroad, almost one-half of the capital stock of the Lake Erie & Western and over eleven million of the capital stock of the Cleveland, Cincinnati, Chicago & St. Louis Railroad Co. were purchased. Besides these it had bought up considerable holdings in other companies. All this ownership had been acquired in addition to dividends, never less than 6%, out of net earnings. In 1902 the railroads made a single purchase out of surplus of $4,728,000 of the capital stock of the Indiana, Illinois and Iowa Railroad Co. The entire capital being $5,000,000.

In municipal utilities we also find the existence of property building out of earnings. Three illustrations are taken from cases which have come before public service commissions.

[2] *I. C. C. Reports.* Vol. XX.
[3] *I. C. C. Reports.* Vol. XX, p. 269.
[4] *The London Statist*, Dec. 17, 1910.
[5] *I. C. C. Reports.* Vol. IX, p. 382.

The Haverhill Gas and Light Co. was organized under a special charter in February, 1853, and later in that year began the supply of gas in Haverhill. Its capital stock was originally $45,000, which was increased in 1871 to $75,000. It has enjoyed the exclusive privilege of supplying gas to the city and people of Haverhill. Its management appears to have been exceptionally careful and conservative so that, in addition to the payment of an average dividend of 8%, it has accumulated a surplus of earnings invested in its plant estimated to represent approximately $300,000.[6]

A revealing of the facts of the Bridgeport Natural Gas and Oil Company also shows a high percentage of their capital value as flowing from earnings. The investment in the plant as of December 31, 1915, shows

Capital Stock (From Owners)	$11,010.00
Additions and Betterments (Built from Earnings)	35,891.26
Funded Debt	4,000.00
Total	$50,901.26

The net return in 1915 as dividends was $6,800 which on a basis of total capital value including invested earnings, shows a profit of $13\frac{1}{3}\%$. If this return is considered in terms of the cash investment made by the owners it gives a profit of $61\frac{3}{4}\%$.[7]

Again in the case of the Kansas Natural Gas Co., of the $16,000-000 capital over $3,500,000 came out of earnings. This company always paid regular dividends on its stock.

Sufficient instances have been given it is hoped to show the existence of the method of increasing property by investing earnings. The method is not rare. It is such a common experience in public utility financing that any number of illustrations might be brought to our attention if time and space would permit.

III. ADVANTAGES AND DISADVANTAGES OF INVESTED EARNINGS

Many beneficial and advantageous results come from the investing of earnings in property.

(a) For instance such a method of investment may be the only

[6] *Repts. The Board of Gas and Electric Light Commissioners.* Mass., 1915.

[7] *In re Bridgeport Nat. Gas & Oil Co. P. U. R.* 1916, p. 253.

available means of securing funds to extend and improve the property. Where improvements are made which do not result in increasing the revenue, such as the building of terminals, constructing tunnels or removing grade crossings, it may prove, in fact it has proven, that it is easier to make these improvements from earnings than it is to go out in the market and sell securities in order to finance the undertaking.

(b) Again the existence of a large surplus invested in plant forms the basis of securing good credit. The existence of such a surplus, as was shown in the Eastern Rate Case, does much to make the floating of loans, etc., an easy undertaking.

Under this benefit might be considered the advantage that comes in having a surplus to carry a company over "the seven years of lean." The maintenance of a funded reservoir which may be drawn upon in times of famine is certain to give stability to the financial condition of the utility company. The Montreal street railway franchise, which will be noted at length later, provides for the establishment of a surplus for just such a purpose. One per cent of the gross earnings is put annually into this fund until it reaches $500,000. It is built to take care of unexpected happenings that may tend to embarrass the finances of the company.

(c) The maintenance of a surplus also ties in with efficient operation. A company running on a hand to mouth existence can do little in the way of experimentation or the trying out of new policies. The existence of the surplus allows the company's policy to become flexible and thereby permits excursions into new practices which may or may not prove successful.

All the advantages that accrue with having a surplus do not mean that the surplus must be capitalized. The opposite is more likely to be advantageous. And right here it is important that attention is called to the distinction. As soon as a corporate surplus is capitalized, it loses its advantages as a flexible fund or as a balance wheel for the company's finance. Once capitalized it goes out as a decided advantage to the stockholders, but ever after becomes invested capital calling for dividend payments on the part of the company. That is, capitalization means more dividends to be paid.

It is surplus capitalized which brings up the real problem in

which the public is concerned, as it then represents a direct payment to the stockholders of the corporate surplus created from rates.

The disadvantages of invested earnings may be grouped under four heads:

(a) The first disadvantage is the danger of higher charges being made on account of the investment of surplus earnings. A rate large enough to pay all costs including dividends, and sufficient to build extensions and improvements, is to the public a direct over-charge. As was quoted in the Western Rate Case:

In 1899 the unappropriated surplus in all railroads was $194,000,000, whereas in 1909 it was $800,000,000. In ten years with an increase in rate of dividends and increasing maintenance charges and a vastly increased fixed charge for interest, these carriers had accumulated a surplus of $606,000,000 or an increase of 312% over 1899.[8]

(b) Another disadvantage where the policy of investing earnings is pursued is the danger of emphasis being placed upon expenditures for extension and improvements at the expense of service and daily operation. The public should realize that the reward is too attractive to keep the company from placing earnings in investments rather than in service. The former is a real and permanent gain, the latter a direct expense. This was the situation which led the courts in the Monroe Ind. Tel. Co. Case[9] to hold:

> It has been the practice in the past for this company to build as many extensions as possible out of earnings. This has had the effect of increasing the size of the property at the expense of the service, and of the property already in existence. In other words, a more extensive plant has been built than can be maintained at present rates. The time has come when this practice must cease. Additions and betterments must be provided hereafter out of new capital secured out of the sale of stock.

(c) The greatest disadvantage in the policy of investing earnings is the effect it has on rate making. If a property valuation is allowed to be built from earnings and that valuation becomes the basis for the establishment of rates, the possibility of preventing rate increases is very small indeed. Rates are almost bound to

[8] *20 I. C. C. Report*, p. 332.

[9] *P. U. R.* 1915, p. 57.

have a spiral tendency ever moving upwards. The company in addition to paying dividends can well improve and extend its plant at will; and it can rest assured that these additions and improvements will be handed over to the owners, and their valuation form a basis for requesting added revenue. Such a policy, therefore, readily puts padlocks on hopes for rate reductions. How can lower rates be expected when added valuation is shown?

(d) The fourth disadvantage that should be noted, and which is further considered under Invested Earnings under the Régime of Regulation, is the relation that exists between invested earnings and speculation in public utility financing. Those interested in placing utility investment upon a sound basis feel that a policy of enhancing property from rates creates a basis for much speculative activity, which should be discouraged. And it is, therefore, further held that all additions and improvements should come from the sale of securities.

IV. THE ATTITUDE OF COURTS AND PUBLIC SERVICE COMMISSIONS

As an established rule, the courts have held that the invested earnings of a public utility company are the property of the stockholders. A careful survey of all the court decisions point to this ruling. In *Bryner* v. *Butler Water Co.*,[10] Judge Williams held:

> In determining the amount of the investment by the stockholders it can make no difference that money earned by the corporation and in a position to be distributed by a dividend among its stockholders, was used to pay for improvements and stock issued in lieu of cash to the stockholders.

The decision of the Supreme Court of New Jersey in the oft-quoted Passaic Gas Case[11] conveys the same opinion as the Butler Case. The opinion affirmed by the Supreme Court reads:

> If, in the past, this gas company, out of rates exacted from consumers, had met its operating expenses and depreciation, and in addition thereto had obtained enough to pay returns to investors, and to build an actual structure used in this business, would this structure aforesaid be the lawful property of the company? The answer, it seems to us, must be in the affirmative. If the company had paid out, in addition to other payments to investors, dividends equal to the cost of building this structure, and then had issued additional stock in

[10] *Bryner* v. *Butler Water Co.* (1897) 174, p. 231.

[11] *In re Opinion of N. J. Board of Public Utility Commission in the Passaic Gas Case* (1913) Vol. 1, p. 470 and 84 N. J. 463.

value, equal to the cost of this structure in order to repossess itself of the money required to build it, there can be no doubt that the structure built out of the proceeds of the additional securities thus sold would be the lawful property of the company. It would be none the less the company's lawful property if built out of current earnings without the issue of additional securities.

Other court decisions substantiating the above rulings will be found in:

San Joaquin C. v. *Stanislous Co.*, 233 U. S. 459.
Murray v. *Pub. Utility Com.*, 150 Pac. 147.
Fall River Gas Case, 214 Mass. 531.
Grafton County Electric Light & Power Co. v. *State*, 94 Atl. 193.

A court ruling which suggests that patrons have some indirect rights to invested earnings is the findings of the Supreme Court in the Yellow Pine Case, in which it upheld the Interstate Commerce Commission's decision.[12] The Commission found that the carriers had charged as a part of their operating expenses large sums which had, in fact, been devoted to the purchase of additions, new equipment, and to the making of permanent improvements to their roading and structures, and held that those items were not properly chargeable as operating expenses, for the reason that the shipper of today could not be properly required to pay the entire cost of an improvement or addition which was to be of permanent use. The case is one in re rate advances and definitely holds that the patrons of a railroad will not be compelled to pay a rate so large as both to pay dividends and to build up a surplus to be invested in extensions or improvements. This case, however, is a rate case and not one dealing with the question of ownership. Up to the present time the courts have unanimously held that surplus belongs to stockholders and the Yellow Pine Case does not conflict with this general holding.

The rulings of the Courts have constantly held that invested earnings belong to the stockholders. The Public Service Commissions in contrast have taken divergent stands on matters of rights of ownership to surplus; also on whether invested earnings may or may not be capitalized; and on the question of invested earnings as being considered a factor in determining

[12] *Central Yellow Pine Assoc.* v. *I. C. R. R. Co.* 10 I. C. C. Rep. 505. *I. C. R. R. Co.* v. *I. C. C.* 206 U. S. 441.

rates. These different rulings might be grouped under three headings:

First. Rulings of the Commissions determining to whom Invested Surplus shall belong.

Second. Rulings of the Commissions regarding the right to Capitalize Surplus.

Third. Rulings of the Commissions regarding the Surplus as a Rate Making Factor.

Each of these groups will be considered in turn:

(a) *Rulings of Commissions determining to whom Surplus shall belong.*

The most recent case coming before a State Commission as regards the right of ownership of earnings is the Indianapolis Water Company Case.[13] In this case the Indiana Commission held that surplus earnings invested in the plant must be included in determining the amount of the investment made by the stockholders, since such surplus is the property of the stockholders; and when invested in the plant, they are entitled to earnings thereon. This company's accounts showed a corporate surplus of $3,500,000 that would have been in the treasury of the company if it had not been invested in the property or elsewhere. The Commission stated:

This represents the actual corporate savings from income and was the property of the stockholders.

A dissenting opinion by Commissioner Corr is enlightening in that it clearly outlines an opposite point of view. Part of Commissioner Corr's opinion is as follows:

If the Indianapolis Water Company has earned reasonable rates on the value of its property and distributed the same to its stockholders as dividends, and, in addition has paid fixed charges and operating expenses, and provided a proper depreciation fund, then that is all it is entitled to, and any exactions from consumers in excess of this is unlawful. So that, if this surplus which has been reinvested, was so unlawfully collected, over and above just rates, it in equity belongs to the patrons of this company, and cannot be recapitalized against the public.

While the legal and technical title of this accumulated surplus may be in the company, it was unlawfully accumulated, and in equity belongs to those from whom it has been involuntarily exacted. This Commission may have no legal right to order the return of the money thus unlawfully accumulated, and yet it

[13] *P. U. R.* 1917 E., p. 557.

does have the power to, and should prevent the recapitalization of these unlawful exactions, extorted from the public by unlawful rates, against the present and future water consumers of this water company.

The Wisconsin Railroad Commission in *Charlesworth* v. *Omro Electric Light Co.*[14] very clearly held that invested earnings belong to the stockholders. The Commission ruled as follows:

It is quite clear, also, that property paid for out of earnings is as much the property of the respondent as though paid for by new capital. Such earnings might have been first distributed among the stockholders as dividends, and later returned for investment.[15]

The Interstate Commerce Commission suggests that the surplus should perform the function of being a public fund held by the Railroad Company and used for the production of better service. Quoting from the Commission on this point:

There is much persuasiveness in the argument that a surplus shall be permitted to accumulate which shall be in a sense a public fund out of which the carrier may create facilities which will produce more efficient and satisfactory service without adding to the liability of the road and without creating an additional value in the road which may call for a greater return in rates. This suggestion has much that is fundamental in it. It looks toward an adjustment between the public and the carriers that will be fair and profitable to both. It is an expression of the appreciation by the public service corporation of the philosophy upon which public regulation of carriers is based. Moreover some method must be found under which a carrier by its own efficiency and management shall profit. . . . . Society should not take from the wisely-managed railroad the benefits which flow from the foresight, skill and planned coöperation of its working forces.

It would appear that one of the problems of the future in railroad regulation is to discover the machinery by which the railroad may justly take to itself a return for the investment which its stockholders have made, and share with the community the advantages of the surplus which it creates.

. . . . Any attempt on the part of the Commission to declare and carry out such a policy would, we take it, be subjected immediately to successful attack before the courts. Since we cannot declare that accumulated surplus shall not be capitalized, the adoption of such a plan rests entirely with the carrier, and the volume of such surplus as a public trust fund depends entirely upon their own policy and good faith.

The Interstate Commerce Commission has well summed up the control that public service commissions can have as regards the ownership of surplus:

[14] *P. U. R.* 1915 B., p. 1.

[15] *In the Western Railroad Case. I. C. C. Reports*, Vol. 20, pp. 333–34.

Any considerations we have given and any suggestions we have made regarding the rights of ownership of surplus earnings are manifestly addressed to a body having legislative power; and until either by legislative enactment or by a generous attitude of the utility company, the surplus is treated either in whole or in part as a public fund, the matter of ownership will unquestionably rest with the private company.

(b) *Rulings of Commissions Regarding the Right to Capitalize Surplus.*

Two public service bodies—the West Virginia Public Service Commission and the Oregon Public Service Commission—have upheld the right to capitalize or invest earnings. The West Virginia holding is in the Bridgeport National Gas and Oil Company Case.[16] The facts of this case were quoted above.

With so large a proportion as 70% of the investment being built from earnings, the Commission nevertheless held:

In determining a fair return on the amount of capital honestly and prudently invested and having in view the value of the service to the consumer, extensions and betterments paid for out of moneys otherwise available for dividends may be capitalized where the amounts available for such purposes were at no time exorbitant, and in many instances far below a fair return on the investment.

The Oregon Commission in the Portland Railway Light and Power Company Case[17] ruled:

The source from which the money was obtained—whether by original contribution through stocks or bonds, or from corporate surplus—is immaterial in the findings under this head.

In seeming contradiction to these views two commissions—the Illinois and Nebraska Commissions—portray the following:

In re application Citizens' Mutual Telephone Company,[18] the Illinois Commission held:

The subscribers of the telephone utility should not be required to contribute any amount in the form of increased rates or otherwise, toward increasing the capitalizing of the plant, since only the stockholders can share in the return on such increased capitalization.

The Nebraska Commission in the Monroe Independent Telephone Company Case,[19] stated:

[16] *P. U. R.* 1916-C, p. 253.
[17] *P. U. R.* 1916-D, p. 1012.
[18] *P. U. R.* 1915-C, p. 103.
[19] *P. U. R.* 1915-E, p. 57.

It has been the practice in the past to build as many extensions as possible out of earnings. This has had the effect of increasing the size of the property at the expense of the service, and of the proper maintenance of the property already in existence. In other words, more plant has been built than can be maintained on the present earnings. The time has come when this practice must cease. Additions and betterments must be provided for hereafter out of new capital secured through the sale of stock.

It is further ordered that any surplus remaining out of the earnings, after all operating, maintenance and depreciation expenses, and a dividend equal to 7 per cent on the outstanding capital stock, have been paid, shall be applied to the improvement of the service and the maintenance of the existing property; and, unless the approval of this Commission is first secured, none of such surplus shall be expended for the building of new lines or for any additions and betterments.

(c) *Rulings of Commissions Regarding Invested Earnings as a Factor in Rate Making.*

When it comes to a consideration of invested earnings as forming a basis for rate determination, public service commissions have in general held that investments from earnings are not entitled to be considered on the same basis as new investments made from the sale of stocks or bonds. In the Bay State Rate Case[20] the Massachusetts Commission ruled:

Additions and betterments paid out of earnings have no part in the investment to be taken as the basis for rate making.

The same attitude was upheld by the Connecticut Commission in re Stoddard, Gilbert & Company Case.[21] After going into the facts of this case the Commission held that the revenues beyond a return of 8%, for a surplus to be used in extending and building up facilities needed properly to handle business, should not be allowed in the proceeding to determine the reasonableness of street railway freight rates. The Wisconsin Railroad Commission[22] has stated:

In fixing the rates of the municipal utility for municipal and general service it is equitable that consideration should be given to the fact that in addition to paying interest on the funded and floating debt, the commercial consumers have contributed materially to paying off the bonds and enlarging the plant.

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[20] *P. U. R.* 1916–F, p. 222.

[21] *Re Stoddard, Gilbert & Co. Case P. U. R.* 1918–A, p. 610.

[22] *Wisc. R. R. Comm. Skogmo* v. *River Falls, P. U. R.* 1917–E, p. 964.

The Oregon Commission In Re Tualatin Valley Electric Company[23] ruled:

The Commission does not believe that the present customers should be forced to share an undue burden of increased rates because of the neglect of the operators of the utility to provide sufficient capital for a reasonable extension and development of the business which they control.

Possibly the clearest cut attitude as regards the regulation of rates where the company has an invested surplus is stated by the Nebraska State Railway Commission in the Farmers' and Merchants' Telephone Company Case decided April 15, 1918, and not yet annotated. In this case it was agreed that the present value of the company's plant was paid for originally out of the Company's revenues, and in addition thereto most of the rural lines were paid for by subscribers. The Commission took these facts into consideration when the Company applied for an increase in its telephone rates. So important is this case in portraying a newer attitude toward the surplus that it would be well to quote at length part of their decision:

What was and is a reasonable charge for public utility service is such a rate as will produce sufficient revenue to operate and maintain property in a good, serviceable condition, pay taxes, losses and damages, and yield a fair return on the capital contributed by the stockholders which has been honestly and prudently expended for the purpose of furnishing the service. It is evident, therefore, that if the rates collected during the life of the Company produces a revenue in excess of these requirements, the surplus belongs by right to the patrons of the utility and may be recovered for their benefit. If distributed as dividends, an assessment of stockholders will lie or the right of stockholders to earn future dividends suspended until the surplus is restored to the Company's treasury. If invested in additions to the plant, the stockholders may not earn a return upon it or capitalize it, and, per contra, if the revenues in the past have not met the requirements as to operation, maintenance, taxes, losses, damages and return, and assuming that the utility has been providently and efficiently conducted, the patrons are indebted to the utility and rates should be increased sufficiently to discharge the obligation within a reasonable time.

The Interstate Commerce Commission has also considered the matter of invested earnings in its relation to rates. In the Eastern Rate Case, it was held:

It would appear, therefore, that both the court and the Commission are committed to the proposition that in fixing a fair return upon railroad property for the purpose of determining whether a given advance is reasonable the railway

[23] *P. U. R.* 1918-A, p. 596.

ought not to treat as a part of its operating expenses the cost of permanent improvements or extensions, and this must of necessity mean that the rates should not be sufficient to allow both the payment of dividends to stockholders and interest to bondholders, and an additional sum for the purpose of improving and increasing the value of the property.

In scanning the cases before the different public service commissions involving the problem of invested earnings, one is impressed with this important fact: there is a broad and far extended awakening to the issues attached to earnings which are turned into property. Commissions are finding that their existence demands a different kind of consideration than does that form of property which is purchased through stock or bond sales. In the establishment of a fair rate of return the commissions are beginning to see that invested earnings carry a responsibility to the consumers and to the public which must not be over-looked.

V. INVESTED EARNINGS UNDER A RÉGIME OF PUBLIC REGULATION

The surplus earnings of public utility companies which find their way into extending and improving property value must be viewed differently under a régime of public regulation than they were wont to be considered in the days of little or no public control.

When only a very small amount of ineffective regulation was in existence, the public assumed no responsibility in seeing that a fair and just return was paid the investor. Risks were assumed by the investors in which these investors played the game of getting all they could and in turn they were supposed to stand ready, to carry any losses involved. By the very nature of things they played the speculative game which to some meant very large returns—real, colossal fortunes—to others, serious losses. Stock watering, bribing of legislation, controlling appropriations, falsifying accounts, hiding and camouflaging large earnings, all came into prominence as profitable activities. If the rates seemed to be too high, the fact could be readily concealed by putting surplus earnings into betterments and additions and thus increase capital investment without taxing the holders of securities. Public utilities under such a period of financing created the most likely and most natural result—a hatred, a suspicion, and a spirit of revenge in the public mind. And from that condition

was born the era of regulation as a controlling influence over public service corporations.

The main purposes of regulation are to see that service is provided the public, and that fair and equitable relations are maintained among the public, the patrons and the owners. In establishing fair relations a control over rates is necessary. Public authority steps in and determines what it considers a just return. And this form of public regulation, as it further and further develops, places our problem of invested earnings in a new and different light.

As the public assumes this greater control over utilities, the public, rather than the private company, must be prepared to meet the losses, and share in the benefits that such control entails. The public must pay for utility service at cost whatever that cost may be. If there are any uncertain or speculative features, the public must in turn carry the burden. As far as the investors are concerned, the speculative element is on the wain and an era of sound investment is coming to the fore.

Seeing this change in public utility financing, the surplus and invested earnings take on a greater social significance. If, through the effects of regulation, the public stands willing to pay the costs of service, which costs cover a fair return on the investment, then any surplus created is a fund in which the public in equity at least have certain rights; and if the surplus is invested and capitalized, still further rights are involved.

The control by the public naturally brings up the question as to what constitutes a reasonable charge for utility service. It seems reasonable that a rate to be fair and just, should cover:

(a) All operating expenses, including payments of damages, etc.

(b) All maintenance, up-keep and depreciation charges.

(c) Taxes.

(d) A fair return on the investment, made by the stock and bond holders.

Therefore, if we accept these costs as fair and reasonable, then any further revenue in excess of these charges is a fund overcharged the patrons and which belongs by right to them. And here is the real gist of the invested earnings problem. *As we change from an era of little or no public control to an era of regulation and public responsibility, the corporate surplus built from earnings,*

whether invested or not, becomes a factor in public utility financing in which the patrons have a direct interest.

The Supreme Court's findings in the Yellow Pine Case[24] bear witness to the same thought, when it ruled that the patrons of a railroad should not be compelled to pay a rate so large as both to pay dividends and to build up a surplus to be invested in extensions and improvements.

Let us not lose sight of the fact that as regulation grows in scope and influence it almost automatically changes unsecured, speculative risk takers into sound, secured investors. And as this change takes place, corresponding changes present themselves as regards the rights to surplus and invested earnings.

A more practical view is obtained when we consider the attempts that are being made to put the corporate surplus in a place where the patrons and public share in its benefits. This brings us to a consideration of the efforts and opinions of those in actual control and responsibility, who are trying to gain a greater socialization of the corporate surplus.

VI. SOCIALIZING THE CORPORATE SURPLUS

Mr. Walter D. Hines, Director General of the Railroad Administration, realizes the importance that surplus created out of railroad rates should not be capitalized but should be shared with the public. This socialization of the surplus is suggested when he advocates:

> There ought to be a prescribed rate of return to which the railroads are entitled and that ought to be assured by some mandatory or statutory provision. The rate must be so fixed as to produce that return and beyond that, I think it ought to be provided that if an additional return shall be yielded from those rates, a sum to be determined for that purpose is to be put back into the property for improving the property in order to keep pace with the increase in demands for business, and that the money thus put into property out of earnings shall not be capitalized so as to further add to the value of the property. That would provide that the earnings made in excess of what was necessary to operate this property upon a standard return would be put back into property without being capitalized. This would lead to the public getting the improvements and they would not have to pay for this exploitation without any limitation of the public having the benefit thereof.[25]

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[24] 206 U. S. 441.

[25] *Address before the Philadelphia Chamber of Commerce*, June 20, 1919. Quoted in the *Phila. Public Ledger*, June 21, 1919.

The Association of Railway Security Owners in their proposed railroad plan shows a disposition to socialize the corporate surplus and to a certain extent prevent the capitalization of earnings. The earnings in excess of a fixed reasonable return are to be distributed among the employes, the railroads earning them, and *for certain improvements not to be capitalized in rate making.*

Again Mr. Paul Warburg and Mr. Victor Morawetz in their respective railroad plans suggest methods whereby the surplus earnings shall be divided between the owners and the government and possibly with labor.

Mr. Warburg would have all returns between 6% and 7% divided with the government and perhaps with labor. The earnings over 7% would go to the government in their entirety. Mr. Morawetz suggests a government guaranteed dividend of 2½% while any returns netting in excess of 4% shall be divided with the government.

That the public is entitled to share in the surplus earnings is the attitude expressed by the directors of the American Telephone & Telegraph Co.[26] These directors have evidently accepted the conclusion that the surplus shall constitute a trust to be administered in the public interest. They express the view that "ample reserves should be provided to meet not only probable happenings but possible happenings, and that such reserves should be so invested that whatever increment or revenue is to be derived from the amounts unexpended will go to the public in reduction of charges or in improvement of service."

The method or machinery for putting surplus earnings into the hands of the public is best and most definitely seen in the franchise stipulations of the Montreal Street Railways. This franchise marks the dawn of a new day in utility financing and heralds an era of greater coöperation between the public and their public service corporations. It is decidedly worth our while to consider carefully some of the important stipulations of this franchise.

(a) *A valuation on the property* was made by the Public Commission and fixed at $36,000,000.

(b) *A guarantee fund* of $500,000 is created by the owners, which is to be used to meet any excess operating expenses over the amount allowed by the Commission.

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[26] *Report of Board of Directors,* March, 1912.

(c) The franchise calls for the following regulations regarding gross earnings:

1st. That the Commission fixes *the standard of service*, and grants operating allowance per car-mile, both for motors and for trailers. The allowance is based on a six months' period.

2nd. If the Company keeps within this allowance, plus $2\frac{1}{2}\%$ leeway, they are then allowed $\frac{1}{8}$ of 1% *additional profit on the valuation.*

3rd. If the Company spends more than the allowance, then *the excess comes from the guarantee fund.* This fund to be kept up by the owners to $500,000.

4th. If unforeseen and extraordinary conditions call for an increase in operating expenses, *the Company may get a special grant from the commission*, which will offset the rulings above.

(d) *Depreciation.* The property is to be maintained at high efficiency, and to accomplish this a certain number of cents per car-mile are to build up a depreciation reserve of $500,000. The Commission reserves the right in the franchise to pass upon all expenditures.

(e) *An allowance of 6% on the capital valuation is allowed*, and during the period of the war this has been increased to 7%.

(f) A sum of $181,000 per year is set aside into *a fund to be used to cover discount necessary to obtain new capital.* This fund, therefore, is a preventive of any water getting into the capitalization.

(g) *The Contingent Reserve.* 1% of the gross earnings is put annually into a contingent reserve which is used to meet any extraordinary expenses. This is to be kept up to $500,000.

(h) *The Surplus.* After all expenses, costs, dividends and interests have been met, the remaining amount of net earnings is thrown into surplus. This amount is divided annually upon the following basis:

30% to go to the City.
20% to go to the stockholders.
50% to go into a fund termed "The Tolls Reduction Fund."

When this Tolls Reduction Fund reaches $1,000,000, the City may, or when it reaches $2,500,000 the City must, reduce the fares. If, on the other hand, the earnings are so low as to use up the Contingent Reserve, then fares must be increased.

(i) *If the Contingent Reserve of $500,000 falls to $300,000*, then the Tolls Reduction Fund may be called upon to replenish the Reserve, bringing it back to $500,000.

This Montreal franchise is the best instance of a contractual relation between the private companies and the public, which has removed public utility financing from the field of speculation and has placed it upon a sound investment basis. Owners, patrons and the City, each share in the surplus; and a board of control is provided to which each has the right to appeal.

Perhaps the most salient feature is the regulation regarding management. The speculative element is removed and at the

same time there is provided an incentive for efficient management by allowing an additional operating profit and also a company's share in any surplus that may be created. It likewise places upon the management a penalty for inefficiency of operation. By the Public Commission's placing limitations on operating expenses that may be made, the management finds it necessary to keep within these bounds or else finds that the company is forced to make up excess costs. It is well to note that this plan thus removes the "cost-plus system"—which system passes the burdens of inefficiency on to the consumer.

This franchise has been in effect only a little over a year—too short a time for determining its permanent value as a means of financing public utility corporations. Its importance at present consists in calling to our attention the fact that definite attempts are being made to put into effect a financial method which shares the surplus earnings with the public, and which has eliminated the evils that go with the old form of speculative finance.

The problem of gaining complete coöperation between the public and the private utilities has in no ways been fully achieved. Possibly any final solution, where real coöperation exists, is impossible under private ownership, and the outcome will be nothing short of public ownership and public operation. Most certainly the railroad situation points that way.

But only as the financing of public utilities is redeemed from the speculative régime and placed upon a scientific and sound basis of investment, can real progress be made in public regulation and security of investment.

Such a basis of investment must make the public pay for the costs of all the service rendered, including a fair return on investment; and such a basis must also make the dangerous event of the public paying more than these costs an absolute impossibility.

DISCUSSION

By H. M. Beardsley

It seems almost invidious to start this discussion with a criticism but personally I wish that Dr. Reitell had been more explicit and definite in Section II "Facts of Invested Earnings." Perhaps the railroads and gas companies have shared with the public more of the surplus earnings than really appears on the face of the figures set forth. For instance the President of the Pennsylvania Railroad is quoted as testifying that since 1887 his road had appropriated $262,000,000 from earnings to use in improvements and betterments. If he made that statement in 1917 the period covered was 30 years and the amount equalled $8,733,333 per year—not so much if it paid for all the grade crossing elimination which took place during that period. Surely the public received its dividends on that in increased safety, and the rate of fare charged by the Railroad was not increased.

Again a look at some of the cars and locomotives now running on branch lines which used to run on through trains on the main line and which have replaced still smaller cars now relegated to the scrap heap will illustrate another way in which surplus funds have been invested for the benefit of the public as well as of the owners.

In the case of the Haverhill Gas and Light Co. also, a little more information might show that although $300,000 had been invested in the plant from surplus earnings for the benefit of stockholders from 1853 to 1915 (only $4,838 per year) enough of the earnings had been socialized to be of distinct advantage to the public. In the one matter of rates for instance, my information goes to show that in 1853 gas companies generally charged from $2.50 to $3.00 per 1,000 cu. ft. for gas, whereas in 1915 the companies charging as much as $2.00 per thousand were in the minority and the average rate in cities the size of Haverhill, and located as Haverhill is with reference to coal market, would more likely have been $1.50 or perhaps even less.

Surely in this case the "advances in the art" and the growth of population which forced the company to make a larger investment (on which it received 8 per cent) brought equally as great advantages to the public in reduced rates. I freely admit that I am dealing only with suppositions as to the actual amount of

rate reductions but that there were substantial reductions I firmly believe.

Under Dr. Reitell's third caption he carefully sets out the advantages and disadvantages of investing earnings. Surely no one could take exception to his clear, complete and eminently fair exposition of those advantages and disadvantages. There is absolutely no question but that the charging of rates by any public utility corporation, which are high enough to provide for upkeep, interest on the investment *and* the development of the property by the extension of its lines is a distinct social disadvantage. Such charges should not be permitted.

The question is, just where shall the line be drawn? And if the line is drawn carefully and satisfactorily in one case, it is by no means certain that a rule can be built up on that line which will be equitably usable in all cases.

It may be readily conceded that all extensions and additions to the property of a utility corporation should be paid for by money acquired through additions to the capital account. Perhaps the line can be drawn just there, and to prevent the capital account from becoming unwieldy (thus calling for a larger depreciation reserve also tending to keep up rates) it might be provided that improvements to existing plant should be paid for out of the rates received and rates kept up accordingly. I refer to such matters as changing 40 pound rails to 70 pound rails and 70 pound rails again to 100 pound rails; the changing from earth ballast to rock ballast; the changing of horse cars to cable cars and the cable cars to electric cars; the changing from belting and counter shaft to direct connection and from that again to the turbine unit and so on almost indefinitely. I have no doubt that under former practices many corporations capitalized each one of such changes as it was made so that in the end the public was paying dividends on all the equipment ever in use, many years after some of it was sold for scrap. Most Public Service Commissions now allow of course the capitalization of only the excess value of the new over the old or the equivalent of that. Perhaps, as suggested above, it would be better to capitalize only definite additions to and extensions of the plant, but let the present public which is enjoying improvements of existing plant pay for them.

As to the attitude of courts and commissions,—this changes and will continue to change with growing appreciation by both of the facts involved. Such facts for instance as are set forth so clearly in Dr. Reitell's paper. I cannot leave this point without commenting on the quotation from Commissioner Corr's dissenting opinion in the Indianapolis Water Company Case. His mention of "unlawful exactions" "unlawfully collected" seems to conflict with his admission of "the legal and technical title." It is for Commissioners to take the forward stand (the fact that we have Public Service Commissioners is a forward step) that such rates are improper and not consistent with public welfare and when the public has a reasonable basis for its acts and a good understanding of the equities involved (instead of an unreasoning hatred of all things corporate) public opinion and the court decisions will soon fall in line with the views of the most advanced Public Service Commissioner who is performing his duties with due regard to his oath of office. The Interstate Commerce Commission well says in the passage quoted: "Moreover some method must be found under which a carrier by its own efficiency and management shall profit—Society should not take from the wisely managed railroad the benefits which flow from the foresight, skill and planned coöperation of its working forces. It would appear that one of the problems of the future in railroad regulation is to discover the machinery by which the railroad may justly take to itself a return for the investment which its stockholders have made, and share with the community the surplus which *it* creates."

This brings us logically to the final section of Dr. Reitell's paper "Socializing the Corporate Surplus," in which he shows how some of the best operating and financial men are beginning to look at the problem. The Montreal Street Railway franchise seems most decidedly a step in the right direction and it would seem that greater publicity for this plan would be most helpful. The rate of return on the capital invested seems adequate and large enough to bring out more funds when necessary. The guaranty fund put up by the owners and the contingent reserve fund taken from the earnings are sufficiently large to warrant the public to expect the best of service and of equipment. It will be interesting to learn just what will happen to the fund of

$181,000 per year set aside from earnings as discount on new capital if capital is obtained at par.

Such a contract seems to be almost ideal in scope and aim and certainly is a middle ground worth trying out by both the exponents of private enterprise and those holding for municipal ownership pure and simple. The latter may be correct theoretically, but it would seem that until municipalities learn to run their police departments, their fire departments and their street departments without the scandals of the past it would be wiser for them to refrain from too great excursions into the departments of finance and operation involved in the operation of our Public Utilities.